

INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF REGULATION
23038(a), REPEAL OF REGULATION 23038(b), AND ADOPTION OF REGULATIONS
23038(b)-1, 23038(b)-2, AND 23038(b)-3.

Section 23038 of the Revenue and Taxation Code (R&TC) was enacted in 1953. Regulation §23038(a) was adopted on July 13, 1973, and effective 30 days thereafter. Paragraphs (2) and (3) of subsection (a) of the regulation were amended in 1996, effective as of January 1, 1993, so as to conform, as nearly as statutorily possible, to the state and federal law relative to the tax classification of unincorporated business entities. Because of statutory constraints within R&TC § 23038 the conformity process could not be complete. In December, 1996, the IRS issued final regulations under Section 7701(a)(1) and (2) of the Internal Revenue Code (IRC) which substantially revised the criteria for determining the tax classification of an unincorporated business entity as a corporation or partnership. These federal actions were heralded as highly favorable progressive change by the tax professional and business community. The R&TC does not conform to IRC § 7701(a). However, legislation has been introduced which revises Section 23038 of the R&TC and directs the Franchise Tax Board to adopt regulations thereunder which substantially conform to the newly enacted federal regulations. This project is being commenced at this time so that little or no delay will occur between the probable enactment of the pending state legislation and the implementation of the regulations, a result that is being sought and encouraged by the California business community.

SPECIFIC PURPOSE OF THE REGULATION

This proposal will repeal existing business entity tax classification guidelines applicable to all unincorporated business entities, including Massachusetts or business trusts, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and a variety of foreign entities. Further, the proposal will adopt regulations which are substantially similar to the federal regulations (which essentially allow qualified business entities to elect between partnership or corporate classification for tax purposes), and impose a statutorily mandated classification consistent with an entity's federal tax classification. This proposal will also revise existing language to include bank within the meaning of the term "corporation."

Except for the revenue estimate prepared by the Franchise Tax Board Research Bureau, which is included in the rulemaking file and available upon request, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing the amendment of this regulation except for the federal regulations to which this proposal relates.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS.

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation.